CONSULTING ASSISTANCE ON ECONOMIC REFORM II

REPORTS

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Madagascar
The Financial Sector at the Start of the 21st Century: Diagnostic and Directions

Pepe Andrianomanana and
Clive S. Gray, editors

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For information contact:
CAER II Project Office
Harvard Institute for International Development
14 Story Street
Cambridge, MA 02138 USA
Tel: (617) 495-9776; Fax: (617) 495-0527
Email: caer@ksg.harvard.edu

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The Financial Sector at the Start of the 21st Century: Diagnostic and Directions

November 2000

Centre d'Etudes Economiques
Université d'Antananarivo

John F. Kennedy School of Government
Harvard University
Cambridge, Massachusetts, U.S.A.

MADAGASCAR'S FINANCIAL SECTOR AT THE START OF THE 21ST CENTURY

A study carried out by a multinational team under the auspices of USAID's Consulting Assistance on Economic Reform (CAER) II Project

Prof. Pepe Andrianomanana,
Centre d'Etudes Economiques, Université d'Antananarivo
Alain Pierre Bernard, Economist-statistician,
General manager, APB Consulting, Antananarivo
Dr. Clive Gray, John F. Kennedy School of Government,
Cambridge, Massachusetts, USA
Prof. Fouzi Mourji,
Université Hassan II, Casablanca, Morocco
Hery-Martial Rajaonarimampianina, cga,
Expert comptable, Antananarivo
Prof. Louis Rajaonera,
Faculté de Droit, Université d'Antananarivo
Léon Ramamonjisoa,
Consultant, Antananarivo
Dr. Jay Rosengard, John F. Kennedy School of Government,
Cambridge, Massachusetts, USA

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MADAGASCAR'S FINANCIAL SECTOR AT THE START OF THE 21ST CENTURY

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[*Note: the present document extracts the first 30 pages from a 250-page report in French, entitled "Madagascar: Le secteur financier à l'aube du 21ème siécle : Etat des lieux et orientations". For the most part, these extracts were drafted originally in English. The full report is distributed by the Centre d'Etudes Economiques of the University of Antananarivo, 101 Antananarivo, Madagascar.*]

MADAGASCAR'S FINANCIAL SECTOR AT THE START OF THE 21ST CENTURY

PREFACE

The present study was carried out during September 1999-November 2000 pursuant to a USAID Task Order. The Task Order states the following objectives for the study:

- *Furnish the Government of Madagascar, agencies in the private sector, USAID/Madagascar and other international donors an analysis of progress in the financial sector from 1991, its current state and the principal challenges that it will face in the coming decade;*

- *Provide guidelines for the implementation of reform measures in this sector which USAID/Madagascar can employ in the near and medium term.*

In 1993 the World Bank published a report entitled *Madagascar—Financial Policies for Diversified Growth*. The report was the outgrowth of two Bank missions that visited Madagascar in 1991, with the object of formulating a short- and medium-term strategy for development of the country's financial sector.

The present study takes the Bank report as its point of departure. The methodology followed in regard to most dimensions of the financial sector was to summarize briefly the diagnosis and recommendations of the 1993 document, analyze the evolution from 1991 to the present, identify the major obstacles encountered in implementing the report's recommendations, diagnose the current situation, and offer revised or new recommendations for the years immediately ahead.

In consultation with the USAID mission in Madagascar, USAID/Washington's Global Bureau, the office responsible for managing the Consulting Assistance on Economic Reform (CEAR) II project, assigned responsibility for coordinating the study to Harvard University's Institute for International Development (HIID)[1]. In line with its long-established policy, HIID sought to maximize the participation of Malagasy researchers in all facets of the study, including both diagnosis and policy recommendations. Accordingly, HIID entered into subcontracts with five Malagasy researchers, who severally and jointly drafted more than half of the present volume.

The researchers in question, and their primary fields of expertise, are:

Prof. Pepe Andrianomanana, Centre d'Etudes Economiques, Université d'Antananarivo - macroeconomics and monetary policy, team leader;
Alain Pierre Bernard, Economist-statistician, general manager, APB Consulting, and former research director of the recently privatized state bank BTM - banking sector;

[1] On June 30, 2000, HIID was dissolved and many of its personnel and functions absorbed by Harvard's John F. Kennedy School of Government.

Hery-Martial Rajaonarimampianina, cga, Certified Public Accountant - financial transparency and accounting;

Prof. Louis Rajaonera, Faculty of Law, Université d'Antananarivo - legal environment for financial development; and

Léon Ramamonjisoa, consultant - microfinance.

With a view to bringing expertise to bear from a developing country, classified as lower-middle income by the World Bank (2000), with much relevant experience in developing its financial system, HIID subcontracted with Prof. Fouzi Mourji of the University of Casablanca economics faculty. Prof. Mourji made particular contributions to the study in regard to the macroeconomic framework, public finance, leasing, and conditions for development of a securities market.

Dr. Jay Rosengard, coordinator of HIID's financial institutions development program, brought international comparative experience to bear on the issue of microfinance in Madagascar. The third non-Malagasy participant, Dr. Clive Gray, institute fellow, HIID, served as coordinator of the study.

The foreign researchers spent a total of 13 person-weeks on the study in Madagascar, with visits taking place in September and November/December 1999, and January/February and October/November 2000. Meetings of most or all team members present in Antananarivo took place during these visits. Members exchanged draft sections of the report, and comments thereon, by e-mail, and elaborated these further in the team meetings. All sections of the report have benefited to a greater or lesser extent from comments and suggestions by team members other than the principal authors.

A major role in defining research objectives and strategy, providing information, and commenting on draft report sections was played by a Research Supervision Committee (RSC), consisting of senior representatives of government, the private sector, the World Bank and International Monetary Fund (IMF), and USAID. The committee met three times, in September 1999, May 2000 and October 2000. Co-chairing the committee were:

Mr. Henri Bernard Razakariasa, Directeur du Crédit, Banque Centrale, and

Mme. Andriambololona Vonintsalama, Directeur Général du Trésor

Other members of the RSC were:

Mme. Sahondra Raveloson and Mr. Ricky Andriamparany, representing the Association Professionelle des Banques (APB)

Mr. Thierry Rajaona, associate, FTHM Conseils, representing the Groupement des Entreprises Malgaches (GEM)

Mr. Roland Rasamoely, Director General, Ny Havana (insurance company)

Mr. Dieudonné Randriamanampis, economist, World Bank/Madagascar

Ms. Mary Norris, director, Office of Democracy & Governance, and Messrs. Fidèle Rabemananjara and Bobby Dean, economists, USAID/Madagascar

Messrs. Xavier Maret and Gregory Dahl, resident representatives, IMF/Madagascar

Mr. Renaud Rajaonah, Exec. Secretary, AGEPMF (executing agency for World Bank-supported microfinance project)

The eight members of the research team are indebted to the RSC members, as well as to other officials of the Government of Madagascar, stakeholders in the country's financial sector, and staff of donor agencies, who gave freely of their time to advise the team and provide it with access to information. The members hope that the present report will contribute to defining a strategy for advancement of Madagascar's financial sector at the outset of the 21st century, and promoting the adoption of measures by which the sector can help to accelerate Madagascar's economic growth.

MADAGASCAR'S FINANCIAL SECTOR AT THE START OF THE 21ST CENTURY

EXECUTIVE SUMMARY

The basic approach of the present report is to update the World Bank report, *Madagascar—Financial Policies for Diversified Growth*, published in 1993 on the basis of data thorugh 1990-91. It was felt that enough had happened in the interim to warrant preparing a diagnostic of the situation of Madagascar's financial sector and proposing the critical steps to be taken in the next few years in order to maximize its contribution to the country's economic growth.

Economists are not in full agreement as to how far a country's financial sector can lead the real economy in promoting the latter's growth. However there is a broad consenus that deficiencies in the financial sector can retard growth. Accordingly, this report sets out to identify those deficiencies and recommend steps to correct them.

Political turmoil early in the 1990s led to a relaxation of fiscal and monetary discipline, culminating in inflation rates of 39-49% during 1994-95. Political interference with management of two state banks generated portfolios where close to 40% of loans were nonperforming. Madagascar's financial "depth" had diminished to the point where its ratios of money supply and bank credit to GDP were below those of at least 17 other Sub-Saharan African countries.

Stabilization of the macroeconomy started with floating of the Malagasy franc exchange rate in 1994, and inflation dropped to 4.5% in 1997. By the end of the decade, the two state banks had been privatized, and two Mauritian banks had entered the country, whose banking sector now comprised six private, multinationally-owned institutions. There were indications that financial depth had reached a low point by the end of the decade, and the banks are now positionned to increase the role of credit in the economy.

However some important reforms are necessary for this to take place. Firstly, Madagascar's legal-judicial system is not providing the support necessary to ensure a dynamic banking system. Courts tend to support borrowers in their moves to renege on loan contracts (the report describes some typical cases of this behavior.) Banks have reacted with caution by limiting credit largely to short-term loans to their strongest clients. Otherwise they prefer placing their funds in government securities, and are disinclined to compete for deposits by offering attractive returns. The government, and particularly the Ministry of Justice, must make a determined effort to sensitize the courts and ensure that they provide the support on which banks must rely before they will be willing to take greater risks in lending.

Secondly, the level of financial transparency must increase, in particular the willingness of Malagasy companies to undergo regular, professional audits and submit financial statements to banks and potential investors in bonds and commercial paper (BCP). This will also require a substantial expansion of Madagascar's accounting profession.

Of twelve African countries with populations in the 10-20 million range, Madagascar has the lowest density of banks. The sector's oligopolistic structure, maintained in part by barriers to entry of new banks, makes for high profits and a high cost of financial intermediation, measured as the ratio of gross earnings to assets. In 1988-89 this ratio was around 7%; during 1996-99 it averaged over 8%, compared with levels below 3.5% characteristic of developed economies.

Madagascar's archaic internal payments system burdens the real economy with a variety of costs, including delayed payments and use of ground transport to move documents and cash. Increased use of checks, supported by appropriate security measures, is one way of reducing costs. Government should help the financial sector dematerialize internal payments, shifting over time to electronic exchange of payment data.

With regard to public finance, the government is still absorbing around 50% of available credit. Its budget deficit is well below levels recorded in the mid-1990s, but only when the government becomes a net saver will it avoid two effects that are detrimental to development of the productive economy, namely (i) crowding out of the private sector from access to credit, and (ii) upward pressure on borrowing rates, which at close to 30% per annum are still excessive in real terms.

The second effect also makes servicing of government debt a heavy burden on the budget. With a view to reducing this cost, the report proposes an effort to reschedule, in a counter-cyclical manner, components of government expenditure that are subject to flexible timing. In particular, such expenditures should be scheduled so as not to coincide with peak demand for credit, such as for the agricultural harvest.

The report examines pending financial innovations, notably leasing, the BCP market, and the proposed stock exchange. Only one local institution now engages in leasing, which offers many advantages as a means of launching and expanding small and medium businesses with limited financial resources. Current legislation is inadequate, but a new law has been prepared and is proceeding through official channels.

Development of the BCP market provides new, reliable vehicles for saving, and is a prerequisite for eventual establishment of an exchange that conducts trade in equities. It does not require a central physical locale, but can be conducted by a network of professionally trained brokers. As noted above, promotion of this market requires substantially greater financial transparency than is now the norm among companies in Madagascar.

The report issues a note of caution in regard to establishing a stock exchange. The example of the Casablanca exchange shows that, even in a country (Morocco) with a much more sophisticated financial market than Madagascar, companies are reluctant to provide the financial information necessary for participation in a modern market. A 1993 reform induced 37% of then-quoted companies to withdraw from the exchange, in which only about 10% of potentially eligible companies currently take part.

There are proposals that shares held in privatized companies by the Fonds de Portage et de Privatisation could form the core of transactions in a stock exchange to be established in Madagascar. However, for the time being the country would be better advised to promote listing of its strongest companies in a regional exchange such as that of Mauritius.

The report stresses the need to expand availability of financial services, including but not limited to credit, to low income citizens in both rural and urban areas. With support from the World Bank, the government is currently focusing largely on the Mutuelle de Crédit et d'Epargne model. However no country has yet succeeded in replicating this model to the point of causing it to have a macro impact. The report favors diversifying the institutional approach to microfinance in Madagascar. The success of the BRI model in Indonesia puts a premium on encouraging the BTM-BOA (and other banks, if they show interest) to revitalise and expand their outlets and services at fivondronana (district) level outside the principal cities.

Finally, reproducing and updating a 1997 review, the report highlights the backwardness of Madagascar's insurance sector, which for all products except motor vehicle insurance constitutes a state duopoly. Premia account for less of PIB (0,6%) than in many other African countries. Insurance products are expensive, their range is extremely limited, and quality is poor—for example, most claims arising from motor vehicle accidents are contested and settlement is delayed for years. The sector generates only a small fraction of the saving that should be forthcoming from it.

A long-delayed audit should be carried out speedily as a basis for privatisation. Entry of foreign insurers to provide competition and upgrade service should be encouraged. Supervision is effectively nonexistent; it is recommended than an insurance division be established in the banking supervision agency, CSBF, until the sector is large enough to warrant its own autonomous agency.

MADAGASCAR'S FINANCIAL SECTOR AT THE START OF THE 21ST CENTURY

SUMMARY

The present report sets itself three objectives:

1. to take stock of the evolution of Madagascar's financial sector over the decade of the 1990s, following preparation of the World Bank report, Madagascar : Financial Policies for Diversified Growth, published in 1993;
2. to describe the principal obstacles that currently prevent the financial sector from being as effective an aide to Madagascar's economic growth as it could be; and
3. to suggest policies for further development of the financial sector that will enhance its role in promoting economic development.

The report's ***Chapter 1*** summarizes a recent review of professional economic literature regarding the links between financial and economic development. For many years economists have debated whether the financial sector can lead and accelerate development of the real sector. One school of noted economists argues that yes, a dynamic financial sector can stimulate saving, and then, in seeking profitable outlets for the saving, interact with entrepreneurs in such a way as to induce them to invest more and take greater risks to generate production, exports and employment than they would without the sector's stimulus.

On the other hand, another school of economists says that, in the words of a famous British economist, "where enterprise leads, finance follows;" in other words, the sector responds more or less passively to demands for various levels of financial arrangements that arise as the economy's real sector develops.

The review, by American finance economist Ross Levine, concludes that available evidence does not settle the debate definitively. For a sample of 77 countries, Levine finds significant correlations between averages of several growth indicators, and four indices of financial depth: (i) the ratio of the sector's liquid liabilities—currency in circulation, demand deposits, etc.—to GDP; (ii) the role of commercial banks vis-à-vis the central bank; (iii) the private sector's share in domestic credit; and (iv) the ratio of credit to private firms to GDP. Levine also finds that, for 57 countries, the initial (1960) value of the first index, liquid liabilities/GDP, significantly predicts the indicators of growth during the following 30 years.

The significance of credit to private firms arises from the assumption, according to Levine, that financial systems contribute to real growth by "researching firms, exerting corporate control, providing risk management services, mobilizing savings, and facilitating transactions" with respect to the private sector, whereas systems engage much less in such activity to the extent that they simply funnel credit to government or SOEs.

The implication of Levine's review is that it is not possible to predict what if any increase in the rate of GDP growth could be attained by financial reforms leading to specific changes in the main sectoral indices. Nevertheless, experience world-wide, most recently in the disturbances following the East Asian financial crisis that started in mid-1997, demonstrates clearly that shortcomings of policy vis-à-vis the financial sector can

disturb the real sector so as to significantly reduce the rate of economic growth, even make it sharply negative. Many of the chapters in this report describe ways in which such shortcomings have impacted negatively on Madagascar's real economy.

A comparison of Madagascar's indices during 1986-98 with those of various income classes of Levine's 77 countries finds that, on the key counts of financial depth and ratio of private credit to GDP, Madagascar's financial sector falls well below the average for « very poor » countries. Atypically high values for the other two indices—the share of primary banks in total credit and the private sector's share in total credit—are attributed to what might be described as the « hyperactivity » of the state-owned primary banks, a substantial share of whose resources ended up as doubtful and litigious credits to nominally private borrowers.

Significant reforms of Madagascar's financial sector were underway already at the beginning of the 1990s, and others have been undertaken since the 1993 World Bank report. The basic thesis of the present report is that continued implementation of those reforms, as well as application of reforms proposed in the Bank report that were initiated but subsequently reversed, and, finally, implementation of reforms proposed in the Bank report that were never applied, and of reforms newly proposed in the present report, will advance Madagascar's economic growth in such a way as to more than offset the cost of implementation.

The first chapter concludes with an organization chart showing how all economic agents in Madagascar interact within the framework of financial sector reform. The agents identified comprise both the public sector, notably the Treasury and the Central Bank (BCM), and the private sector, beginning with banks and other financial institutions, and including three classes of nonfinancial enterprises, namely, medium-to-large, small-to-medium, and very small or microenterprises.

Chapter 2 establishes an international comparative framework for studying Madagascar's financial sector. Average parameters of the Malagasy economy during the 1990s are compared with weighted averages of the majority of SubSaharan African (SSA) countries, or, in some cases, averages of groups of African countries considered to be most comparable with Madagascar. The comparisons, which relate to five variables of the real macroeconomy and four variables representing the economy's financial status, are illustrated with a dozen graphs.

On the macroeconomic front, Madagascar performed substantially below SSA averages for GDP growth, gross domestic saving, gross investment, and foreign direct investment, and 20% below the SSA average on the government deficit. Average GDP growth was heavily influenced by a 6.3% decline in 1991, arising from political upheaval, and Madagascar's performance during 1997-99, ranging from 3.7% to 4.7%, outstripped the continental average. However, these rates are still far below the 7% needed to achieve the Economic Commission for Africa's target of reducing poverty by half by the year 2015.

The first financial sector indicator presented is velocity of money (M2) in relation to GDP. This correlates inversely with the indicator of financial depth cited above. The lower the value, the more willingly economic agents will hold financial as opposed to real assets. The level correlates positively with the rate of inflation, and negatively with the real rate of interest obtainable on financial assets such as time and saving deposits. (In other words, the higher the real return, the higher the ratio of M2 to GDP, and the lower its reciprocal, the ratio of GDP to M2, i.e. velocity.)

With a 1998 value of 5.4, Madagascar is slightly higher than (i.e. worse off than) the median of 32 African countries. It will be a long time before it reaches the financial maturity of Mauritius, whose velocity in 1998 was only 1.35.

The chapter goes on to compare "density" of banks and bank agencies—i.e. millions of inhabitants per bank or agency—between Madagascar and twelve other African countries with populations in the range of 10-20 million. Its six banks give Madagascar the lowest bank density among the 13 countries, although the BTM-BOA's extensive branch network places the country sixth in density of agencies.

A comparison of bank credit to the private sector in 1998 as a ratio to GDP in 32 African countries ranks Madagascar no higher than No. 20. A time series for 1990-98 relating Madagascar to the simple average of the other countries finds the country slightly above the average through 1993, reflecting *inter alia* imprudent lending by state-owned banks. As privatization and other reforms proceeded, bank credit contracted both as a ratio to GDP and in real terms, leaving Madagascar just above half the African average.

Another measure of a country's financial maturity is the ratio of quasi-money to money. Low ratios normally reflect rigid controls on deposit rates, making time and saving deposits an unattractive investment. As of 1998, a comparison of 43 African countries placed Madagascar at seventh from the bottom. From 1993 to 1998 Madagascar's coefficient declined, as liberalization was offset by the banks' disinterest in attracting deposits, given limited investment opportunities.

Taking all indicators together, Madagascar ranks well below the African median in terms of financial maturity. The remainder of the report seeks to explain this situation, detailing its manifestations in various subsectors of finance, and suggests ways of improving the financial environment for Madagascar's development.

Chapter 3 traces the performance of Madagascar's macroeconomy during the 1990s. It identifies two subperiods, the first characterized essentially by economic stagnation through 1996, and the other featuring modest growth during the last three years of the decade. Performance was strongly influenced by political unrest at the start and end of the initial period, the administration in power since 1975 being ousted in a popular upheaval in 1991, and the succeeding president impeached by the National Assembly in 1996.

In the first years, the Bank report's prescriptions for prudent macroeconomic management were largely overtaken by a relaxation of fiscal and monetary discipline, preventing conclusion of an IMF program and corresponding financial support. The chapter shows the tax ratio declining from 13% of GDP in 1988 to a low of 8.3% in 1994, resulting in a budget deficit that peaked at 6.2% of GDP in 1992, remaining at or above 4% during the next two years. Central bank financing of the deficit doubled money supply in the three years through 1993, but defense of a fixed exchange rate held the increase in the IPC below 40% during the same period.

By 1994 a standard pattern of acute repressed inflation had emerged, with external arrears close to 40% of GDP and official foreign assets at a critically low 10% (equivalent to five weeks) of annual imports. Pursuant to a "shadow" program that the authorities were following with the IMF, the FMG was allowed to float, its value henceforth determined in an interbank market (the MID). At year's end the FMG value of foreign exchange had roughly doubled.

The floating of the FMG initiated a process of recovery, reversing the decline in the tax ratio, reducing the budget deficit, and restricting bank credit so that, in real terms, credit outstanding at end-1996 was 41% below its end-1991 level. Money supply increased by only around 16% per annum during 1995-96. As the repressed inflation played itself out, prices rose by almost 50% in 1995 and 20% in 1996, but less than 5% in 1997. Conclusion of an IMF program, followed by provision of an Enhanced Structural Adjustment Facility (ESAF) in November 1996, allowed rescheduling of foreign debt, so that arrears fell to 16% of GDP at end-1997 and official foreign assets reached 25% (= three months) of annual imports by end-1996.

The chapter goes on to enumerate a set of structural reforms, notably privatization, that moved towards liberalizing the telecommunications, petroleum, tourism and financial sectors, as well as private investment. The 1999-2000 ESAF program foresees expansion of these measures, as well as measures to increase the tax ratio and remove obstacles to competition in areas of rapid growth potential such as mining, fisheries and tourism.

Chapter 4 focuses on the specific role of the BCM in monetary and exchange rate management. Up to late 1990, monetary management emphasized direct methods of controlling money supply and the flow of credit, notably on the one hand ceilings on overall credit and subceilings for each bank, and on the other hand prior approvals. The BCM's independence was compromised by its quasi-fiscal role, notably its responsibility to provide foreign exchange to service government debt at administered exchange rates that overvalued the FMG. Political dictates substituted for BCM prudential supervision in determining the state banks' credit policy.

November 1990 saw the introduction of indirect instruments of monetary management, designed to affect the actions of banks and other economic agents through incentives based on levels of interest rates. For the next five years the BCM used a mixture of direct and indirect instruments. At the end of 1995 credit ceilings were abolished, and after 1996 the only instruments applied were (i) positive and negative auctions (AOPs and AONs), by which the BCM injected or withdrew reserve money from the system via the commercial banks; (ii) required reserves, applied to sight and term deposits; (iii) manipulation of the indicator rate, which increasingly was determined by the AOP market and subsequently the market in Treasury Bills by Adjudication (BTA); and (iv) "open market" operations in BTA, initiated in May 1998. Since August 1998 these operations have replaced the auctions.

Pursuant to a 1992 agreement, the Treasury's debt vis-à-vis the BCM was consolidated and a payment schedule established. The agreement transferred to the Treasury responsibility for external payment arrears and outstanding rescheduled debt borne hitherto by the BCM. Moreover it authorized the BCM to charge interest on its statutory advances to the Treasury and to pay interest on the Treasury's current account balance and other deposits.

The independence of the BCM was reinforced by a 1994 law that provided for the Governor and members of its governing board to be appointed for fixed terms of four years. However, some measures concerning "institutional strengthening of the BCM", recommended in the World Bank report, have not been effectively implemented, e.g.

"establishment of enhanced services for research, prudential supervision and international operations."

At present, the effectiveness of the BCM's indirect instruments is limited by the banks' excess liquidity, arising from their perception of lack of effective demand for credit (see Chapter 8 on the banking sector.) As a result, far from seeking the BCM's refinancing, thus allowing the latter to influence credit by raising and lowering the indicator rate in the manner of other central banks, the commercial banks channel a sizable portion of their deposits into BTA. In these conditions, the BCM has resorted more to the required reserves (RO) instrument than would be called for in a fully market-directed system. The RO was raised in stages from 6% at the start of the decade to 25% in 1994. Following a reduction to 20% in 1996-99 it was raised again to 25% in August 1999.

The preceding chapter described the floating of the FMG in 1994 and its subsequent macroeconomic impact. For two years following the float, exporters were required to deposit 90% of their foreign exchange proceeds with their banks. In 1996 the market was further liberalized by removal of that requirement.

The BCM is a member of the MID management committee and participates for its own account in the market. Service of the public foreign debt, including the BCM's own borrowings from the IMF, comprises its primary requirement for foreign exchange. However the central bank also intervenes to dampen fluctuations in the exchange rate that it believes do not correspond to actual market forces, and to ensure that Madagascar maintains a competitive position vis-à-vis its trading partners. The MID has functioned successfully in this sense, such that, for the past three years, following wider variations that normally follow an exchange rate's sudden depreciation, the real effective exchange rate has remained within a narrow band making the FMG approximately 10% more competitive than in 1990.

By the end of 2000 the MID as a physical locale is scheduled to give way to an electronic network in which banks and, eventually, other participants approved by the BCM can negotiate contracts for purchase and sale of foreign exchange at any time. This technical advance will intensify competition and should narrow the margins currently charged by the banks around the central rate in effect at a given moment.

A further step will be the introduction of term contracts, allowing participants to purchase coverage of exchange risk. Competition will likewise be strengthened by approval and entry onto the market of new exchange bureaus, following the model of other African countries that have floated their currencies.

Finally, the chapter calls for Madagascar to join a tendency of African monetary authorities to take greater initiative in their financial programming vis-à-vis the IMF and other multinational agencies.

Chapter 5, prepared by the leader of our Malagasy team, presents an alternative view of inflation and exchange rate management. Prof. Andrianomanana cites econometric studies (by the BCM, MADIO and others) indicating that depreciation of the FMG has a larger impact on the IPC than changes in money supply or credit.

According to this view, while inflation is a monetary phenomenon in the long run, in the short run, price changes correlate most closely with changes in the exchange rate. With only six participants, in addition to the BCM, the MID is the epitome of an oligopoly. Since demand for foreign exchange is price-inelastic in the short run, the primary banks profit by restricting supply and forcing the FMG onto a downward trend. As for the BCM, its highly variable needs for foreign exchange, largely for servicing public debt, aggravate market fluctuations. The MID's overall instability increases the uncertainty of investment returns.

The chapter attributes responsibility for the decline in financial depth since 1993 to the FMG's float. It describes institution of the MID as premature; rather, this should have followed a package of other reforms, such as widening the market to encompass enough participants to offset the banks' oligopoly. For the time being, the author prefers a directed float, where the BCM would announce its objectives (just as many central banks now announce their inflation targets), and the government would estimate medium- and long-term equilibrium exchange rates as a basis for determining the direction of the float.

Chapter 6 examines the legal-regulatory-judicial environment of the financial system. Its objective is to provide a glimpse of the new business law drafts published during 1999. The main foci are the new law on traders, new provisions on provisional judicial surety, and the law on company transparency. The examination has been extended, insofar as drafts were available, to the main provisions of new drafts that will impact substantially on the financial system, notably those on trading companies and surety.

It is clear that the new provisions represent some progress over the old laws and support the improvement of the financial system as a whole. Thus, the new law on the status of traders provides a better definition of acts of commerce, it clarifies the trader's accounting responsibilities and is more closely linked to the General Tax Code.

The new law on provisional judicial surety constitutes an innovation by way of extending its application to simple borrowers who were previously excluded from the benefits of judicial surety.

The object of this first part of the legal analysis is thus to analyze to what extent and to what limits the new laws tend to favor financial sector development.

Moreover, the analysis of the legal environment also focuses on land ownership rights, notably those aspects concerning real collateral. The land question has always been considered a major obstacle to the development of the financial system, whether in regard to banks' use of land as collateral in providing credit, or to the problem resulting from foreigners' lack of access to land. The provisions of land law clearly need much clarification and certain modifications even if their main characteristics deserve to be maintained.

Finally, the legal analysis has also highlighted the characteristics of provisions regarding leasing that feature in the new banking law. If the introduction of leasing in the new legislation is a major innovation, the fact remains that the new law contains many gaps. In effect, Malagasy law has been essentially focused on establishing provisions on advertising and opposing rights resulting from a leasing contract. What is required to complete these provisions is to deal with basic questions, notably that of exit from a leasing contract in the event of resolution of a sales agreement, the transfer of goods that are the subject of a leasing contract, or, finally, the application of leasing to working capital and nonmaterial elements.

Consideration must also be given to the need to provide leasing with an international dimension in order to perfect the modern character and efficiency of the new financial instrument.

Chapter 7 deals with financial transparency and accounting. An analysis of the situation of the 1990s highlights three aspects that impede the development of the financial system:

- Limited requirements for financial disclosure by companies;
- A virtually static accounting framework. The 1987 accounts code has not been updated since it appeared; and
- Absence of standards for verification of Madagascar company accounts.

In this regard, the chapter discusses production and verification of financial information, the company legal and regulatory framework, and the evolution of the accounting profession.

At present, only banks are legally required to publish financial information and accounts. This is a glaring lacuna, considering that the government's privatization program provides for establishment of a securities market to trade in shares of the companies being privatized. Financial transparency is a *sine qua non* for any company whose shares are publicly traded.

Transparency means not only publication of comprehensive financial statements, but also engaging of external auditors to guarantee accuracy. Corporations (sociétés anonymes (SA)) are required to engage external auditors, which comprises their legal control. This control remains optional for limited companies (SARL). Only 2% of 3,433 companies created during the past three years had the status of SA, and only about 60 SARLs submit voluntarily to external audit. Malagasy businesspeople tend to view it as a useless expense. The current project for reform of Company Law (see Chapter 6) requires legal control for SARLs whose scale exceeds certain thresholds.

Much data has been produced about the companies undergoing privatization, but it has been circulated only to interested parties, not to the public at large. This information should form the nucleus for establishing a register of financial statements with public access.

Updating of the 1987 General Accounts Code is essential, e.g. in regard to accounting for operations in foreign exchange. The Supreme Accounting Council (CSC), which is the organ charged with standardizing accounts in Madagascar and ensuring application and updating of the code, is functioning effectively only since the past year.

The Malagasy accounting profession exists since 1962. Thirty years later it comprised only 17 individuals (3 CPAs and 14 licensed accountants), but the last years have seen rapid growth, with a total of 72 qualified at end-1998. The professional association, OECCAM, has organized a permanent training program. It has also developed audit norms and a code of conduct that became effective in January 2000, and laid a basis for unifying the profession through procedures whereby licensed accountants can qualify as CPAs.

Challenges that currently face the profession include:

- Uncertainty about the probable growth of demand for accountants and corresponding recruitment needs. OECCAM is organizing a study.
- Need to implement the new audit norms, laying a basis for quality control.

- Lack of legislation governing conditions for foreign CPAs to practice in Madagascar.
- Illegal practice by unqualified persons.

Chapter 8 discusses credit institutions. In Madagascar (as in most other low-income countries) the commercial banks dominate this sector. However, only a small fraction of the population enjoys access to banking services. Out of 111 fivondronana, only 41% have bank agencies, and one third of these are concentrated in Antananarivo province.

With only six banks in existence as of the year 2000, Madagascar had the lowest density of banks per million inhabitants among 13 African countries in the size-range of 10 to 20 million inhabitants. Its density of bank agencies was higher—sixth place—due to the relatively high number of BTM/BOA agencies, although this had fallen from 67 in 1990 to 45 in 2000 as the newly privatized bank consolidated its operations.

The decade began with (i) three state banks, BFV, BNI and BTM, formed via nationalization in the 1970s of five mainly French-owned banks, and (ii) one private, likewise predominantly French-owned bank, established in 1989. Such was the political interference in the operation of the state banks that, by 1996, doubtful and contested loans accounted for 37,2% of total bank credit outstanding. (This proportion was as high as 40,7% of short-term credit.)

BNI was privatized in 1991, BFV in 1998 and BTM at the very end of the decade. All three were sold to multinational, mainly French-owned banks. Meanwhile two Mauritius-based banks established branches, in 1994 and 1998 respectively. The state banks' bad loans were transferred to specially created entities for collection, SOFIRE (BFV) and SGR (BTM). As a result, at end-December 1999, bad loans still on the banks' balance sheets accounted for only 5.6% of the short-term credit portfolio.

Resulting partly from the liquidation of bad loans, and partly because the deficient legal environment for enforcement of loan contracts (see Chapter 6) led the reorganized banking profession to perceive an unacceptable risk in lending to all but the most credit-worthy clients, the role of credit in Madagascar's economy declined sharply during the decade. As already noted in Chapter 2, the ratio to GDP of bank credit to the private sector dropped from over 0.17 in 1991 to less than half that level in 1998. There is reason to believe that the latter represents a trough, and that Madagascar's privatized banking sector is now poised to play a growing role in the country's development.

The chapter suggests a number of avenues by which the commercial banks could realize their potential for accelerating Madagascar's development:

- For relatively large companies, the banks can serve as intermediaries in issuing corporate bills or bonds. Intermediation may involve underwriting of issues and guaranteeing the borrower's investment.
- With support from international donors, the banks should participate in creating venture capital firms to provide leverage for average-size companies.
- By underwriting the creation of common investment funds (CIFs), the banks can augment the equity capital of medium-size enterprise with strong growth potential and simultaneously offer new investment products to economic units with surplus liquidity. Funds of this kind already exist in Africa
- Increase the proportion of medium- and long-term loans in their portfolios. This can be facilitated by the potential readiness of some multinational finance agencies, such as the IFC, to guarantee loans made to front-rank companies.

Another approach is to create a mortgage market where banks can mobilize, if necessary, security for their loans based on a mortgage or other claim on real estate.

- Assist the microfinance sector by acting as guarantor for loans from donor agencies to institutions in that sector.
- The banks can also promote the creation of Mutual Security Companies (MSCs). The creation of MSCs, by promoting professional groupings at local, regional or national levels, replaces individual guarantees with a collective one.

While advancing these proposals, the chapter notes that creation and maintenance of an environment conducive to progressive banking presupposes certain policies and measures on the part of the State. This includes:

- giving positive signs of willingness to respect standards of good fiscal and monetary behavior, which includes not subordinating the resources of the financial system to government's fiscal needs, thus avoiding crowding out of the private sector;
- strengthening the legal-judicial system to ensure adequate protection for financial contracts and improve general rules of accounting, audit and financial transparency so as to attenuate the costs and risks of financial intermediation.
- training and sensitizing leaders of public agencies and the public at large to financial questions, in order to facilitate debates, negotiations and taking of initiative.

Chapter 9 examines the domestic payment system. The chapter takes off from a concern over the low level of bank penetration, which raises the circulation of fiduciary money as a proportion of money supply. Thus, 95% of currency is in the hands of businesses and individuals, and only 5% is held by banks and the Treasury.

The system which government itself uses to effect payments is no more efficient than that available to private agents. Receipt by government staff of the media the Treasury uses to pay their salaries, cash certificates and transfers, is subject to long delays, causing staff in the provinces regularly to send representatives to Antananarivo to transport the media.

The problem of increasing the use of checks in Madagascar receives considerable attention. For several reasons, economic agents have little confidence in checks:

- Fraud is widespread—the year 1998 saw around 10,000 payment incidents, about three-quarters of them in Antananarivo. The court system fails to sanction bad checks adequately, within a reasonable period.
- Confirmation of credit for a check drawn on an out-of-town bank agency is typically delayed for several weeks—documents must make a round trip over a highly fragmented road network.
- For agents not located near a bank agency, transactions based on checks involve considerable expenditure of time in travel and waiting at the counter.
- The public at large has not been sensitized regarding the advantages of checks.

Among the chapter's recommendations are:

- Banks should qualify reliable business clients systematically to present their customers' checks for discounting. This will require the clients to present regular financial statements to their banks.

- Establish a central database at the BCM with information on stolen checks, as well as names of persons defaulting on loan repayments, issuing bad checks, or issuing checks despite withdrawal of authorization by the issuer's bank or a court.
- Intensify sanctions for misuse of checks, which includes raising fines overtaken by inflation, and sensitize the judiciary to take these offenses more seriously and apply sanctions rapidly.
- Introduce a photo identification card for bank account holders.
- In the medium term, "dematerialize" the domestic payment system by establishing secure media through which the Treasury, the BCM and the commercial banks can exchange payment data electronically. Since the banks will take some years to recover the costs of this system, some public investment is called for, particularly in upgrading telecommunications.

Chapter 10 concerns the financial operations of the public sector. The principal focus is the management of government domestic debt through BTAs, which have replaced inflationary central bank financing as the source of liquidity to cover budget deficits or peaks in the Treasury's seasonal requirements for cash.

As the 1990s began, outstanding BCM advances to Treasury far exceeded the statutory limit of 15% of the preceding year's ordinary budget revenue. The end-1990 figure was 291%, or almost 20 times the limit. After an intervening reduction the ratio reached the same level at end-1992, but has since dropped below 100% as the Treasury implemented its 1992 agreement (see chapter 4) to begin repaying the advances.

Taking the BCM's claims on government net of government deposits, the ratio of this figure to preceding-year revenue also reached a peak (of 216%) in 1992, dropping well below 100% at end-1999. The Treasury's current policy is not to resort to new BCM advances, and it has not done so in the past two years.

The chapter raises three central questions:

- How far has the Treasury come, and what needs to be done further, to forsake its once privileged access to financing, in favor of meeting its needs in a market where it competes on even terms with other borrowers?
- To what extent does government borrowing crowd out private borrowers who seek credit to produce, export and create jobs? and
- How can the Treasury manage its borrowing via BTAs so as to hold borrowing costs within limits that do not put excessive pressure on the budget?

Treasury came a long way during the 1990s towards fulfilling market conditions. When BTA were first introduced in 1993, only banks were allowed to subscribe directly. Nonbanks could bid only through their banks, enabling banks to know the terms of their clients' offers, giving them an advantage in competing for the best terms. Banks could also more easily mobilize the substantial cash deposits initially required from bidders.

Since 1997 nonbanks, including private individuals, can bid directly, and make the required deposit, now only 5% of the bid, in the form of a check or existing BTA holdings. A special privilege still accorded to government borrowing is that capital gains on re-sale or redemption of BTA are not subject to tax, as are gains realized on other securities.

Recent years have seen a certain integration of the BTA and bank credit markets. Interest rates on bank credit are based on the BCM's indicator rate, which in turn takes account of anticipated inflation. Given the lack of risk, banks bid for BTA yields slightly below the interest they earn from first-rank borrowers. Nonbanks still largely prefer bank deposits to investing in BTA, and in recent months have accounted for only about a third of subscriptions.

For its part, private business continues on the whole to favor bank deposits over investing in BTA, and it recent months it has accounted for only one-third of subscriptions. For reasons indicated in Chapter 8, banks largely confine their lending to these clients, and depositors' funds give them excess liquidity which they gladly invest in BTA. At end-September 2000, government accounted for 52.4% of domestic credit, suggesting a substantial effect of crowding out of the private sector.

Eventually, to ensure free operation of the financial market and accustom investors to financing borrowers other than Treasury, exemption of BTA returns from income tax should be cancelled. The same objectives presuppose also limiting government demand for credit by improving tax collection and earning a recurrent budget surplus for capital investment.

Among its recommendations the chapter suggests that, to minimize cost, Treasury should schedule its borrowing counter-cyclically, i.e. expenditure whose timing is flexible, such as investment in infrastructure, should be scheduled outside periods of high credit demand, such as during the agricultural harvest. Moreover, to ensure optimal management of the money supply, as well as transparency of the BCM's intervention in the money market (based on the current state of the economy, manipulation of the instruments comprising monetary management must be selective), it is desirable to follow closely certain economic indicators.

Furthermore, to optimize the overall strategy of public borrowing and monetary management, the chapter mentions the desirability of constructing a short-term forecasting model of the Madagascar economy, lending itself to simulations. This should be done with the participation of both producers and users of economic information. Another recommendation concerns the databases required to create effective instruments in support of policy-making.

Finally, to enhance flexibility in borrowing through BTAs, adjustments in the present system of adjudication are suggested.

Chapter 11 examines privatization and the financial sector. Chapter 8 discussed the impact of privatization on the banking sector, putting it on a footing where it can finally begin to play an appropriate role in Madagascar's development.

In 1987 there were 175 state-owned enterprises (SOEs). An initial wave of privatization or liquidation of relatively minor companies reduced this number to 101 by end-1992. A 1996 law spelled out the terms for privatizing a new set of larger, more strategic enterprises. The range of formulae envisaged by the law included restricted sales, liquidations, and concession or lease contracts. The absence of a stock market in Madagascar excludes the formula of sales to the public, applied in many countries. The law also did not envisage "management buy out" (m.b.o.), nor management contracts.

Pursuant to the 1996 law, a corporate Fonds de Portage et Privatisation (FPP) has been created, designed to hold provisionally, on government's behalf, a minority share of the equity of every state enterprise alienated by it. The FPP's establishment makes it possible to involve rapidly a strategic investor in the entity being privatized, and to guarantee autonomy in its management *vis-à-vis* government. On the other hand it comprises an instrument permitting participation by Malagasy citizens in privatization.

The FPP will be administered by a professional management company, selected by the Privatization Committee.

According to the FPP's decree, the shares it holds can be transferred to citizens, citizen employees of the enterprise in question (by cash or credit), or to firms the majority of whose equity is held by Malagasy citizens. The question is currently being debated whether the FPP's creation may offer a framework to initiate trading in securities, and whether it would constitute the embryo of a stock exchange.

In 1997 the Government published an initial list of 45 enterprises to be privatized, out of the then total of 101 SOEs. By early 2000, two small companies had been definitively privatized. The activities of SOLIMA (importation, production, storage and distribution of petroleum products) had been uncoupled horizontally, leading to the creation of 11 new companies, of which several had been definitively privatized by mid-2000. In 1999 Air Madagascar was put up for auction, but only one consortium, led by Air France, submitted a complete bid, and the deal has not been consummated amid concern about lack of competition.

Tenders have been issued for a dozen other entities. As for the rest (about 30), the privatization process is at different stages of preparation.

For the sake of transparency, the 1996 law requires the Privatization Committee to prepare an annual report, on the basis of an external audit, giving full details about completed operations, proceeds of sales and disposal of the proceeds. The report is to be approved by Cabinet, submitted to the President, the National Assembly and the Senate, and published in the official journal as well as private media. No such report has been prepared. The chapter asks why the World Bank, given the supervisory role accorded by its Private Sector Technical Support Project (PATESP), has not insisted on preparation and publication of the report.

Chapter 12, dealing with innovations in the financial market, complements (a) chapter 4 on banking reform, designed to impact positively on financing of large and medium enterprises; (b) chapter 10 on financing of the public sector, designed to improve the overall functioning of the credit market; and (c) chapter 13 on microfinance, which outlines steps for aiding the financing of very small production units and micro-enterprises. The present chapter seeks to illuminate what might be done to (i) facilitate the financing of medium and small units, as well as medium-term financing of trading companies, and (ii) promote direct financing.

The three innovations treated here are:

- leasing (directed towards objective (i))
- development of a negotiable securities market (NSM), and
- establishment of a stock exchange (both of these relate to objective (ii)).

The chapter was assigned to our Moroccan team member in order to bring to bear relevant experience from that country.

Thus far one leasing institution, sponsored by the holding company behind BTM-BOA, has been approved in Madagascar. As a means of helping to launch and expand businesses, especially those in the small-to-medium category, leasing offers several advantages in comparison with standard bank credit. Because the security for the credit comprises movable equipment whose title rests with the credit institution until the borrower has fully paid for it, leasing arrangements can be approved faster, with less strict and time-consuming requirements for evaluating the borrower's creditworthiness.

The cost of equipment can be financed up to 100%, and the financing cost is tax-deductible to the enterprise. And leasing can provide medium-term financing to enterprises, particularly those in the trade sector, that do not qualify for medium-term bank credit.

To be sure, these advantages come at a cost—leasing is not available to finance land or buildings; lenders generally restrict it to "standard" equipment with which they have experience, thus reducing opportunities for technological innovation; and interest rates are higher than medium-term bank rates, corresponding to the risk associated with lower standards of creditworthiness. (The bad loan percentage with leasing in Morocco is around 16%.)

In Europe leasing accounts for 15-10% of gross fixed capital formation. With liberalization and deregulation, Morocco's figure, only 2% in 1990, has grown to 4-5% of GFCF. Its experience demonstrates the benefits of promoting competition and easing regulatory restraints on the relevant institutions, so as to realize more rapidly the objectives of leasing.

The promoters of the sole leasing company so far authorized in Madagascar view the tax system as favorable to development of leasing. However an uncertainty remains: when leasing companies sell a good, the procedures for paying VAT on it are unclear. To develop a fair system, the BCM, Treasury and tax department should reach agreement with the industry.

So that leasing companies can estimate their demand, firms should be encouraged to supply complete financial information. One recommendation is to grant tax advantages to firms that have their accounts audited, similar to French practice, for example. In this case the auditors who have certified the accounts are responsible for any irregularities uncovered by tax inspectors.

Development of leasing also requires a supportive judicial environment. Although Madagascar belongs to the continent-wide OHADA, difficulties that banks encounter in collecting loan repayments engender a climate of uncertainty. It is recommended that the authorities emit clear signals concerning regularization of the business environment, in order to inspire confidence in the industry.

An NSM normally precedes establishment of a stock exchange, although some transition economies have tried to develop both in tandem. Before company shares gain sufficient confidence and the regulatory infrastructure is in place to facilitate establishment of a stock exchange, banks and, eventually, professional brokers, deal, both on their own account and on behalf of clients, in fixed-return securities such as BTAs, certificates of deposit, and company obligations. As with all facets of the capital market, development of the NSM depends on creating a culture of diffusion of economic and financial information.

On establishment of a stock exchange in Madagascar, the chapter suggests that Morocco's experience is instructive. A 1993 reform strengthened requirements for financial reporting by companies listed on the Casablanca exchange, which dates from the 1920s. Subsequently 24 out of the then 65 member companies, or 37%, declined to meet the new legal standards of transparency and withdrew from the exchange. Adhesion by new companies, including four resulting from privatization, partially offset this reduction, but membership is virtually stagnant at 54 companies, only one-third of them industrial.

This compares with an estimated 500 companies that could qualify for membership if they so desired and were willing to generate and publish the required information. While the value of transactions quadrupled during 1995-99, the exchange has not fulfilled its intended role as a source of new capital for industrial development in Morocco.

Operating a stock exchange involves trained personnel carrying out numerous functions that have to be financed from commissions on transactions. It would be premature to establish one in Madagascar before there is a critical mass of companies willing to "play the game." As shown in Chapter 7, much remains to be done to create the necessary information culture. The chapter concludes by proposing, as a temporary and intermediate solution, examination of the prerequisites for major Malagasy companies to be quoted on Mauritius' stock exchange.

Chapter 13 deals with microfinance. This subsector aims to promote national development by providing financial services to low-income citizens lacking access to the banking system, thereby increasing their output and income. The principal services are:

- formal credit for microenterprises,
- safe and remunerative depositories for household saving, and
- transfer of funds and other services.

The goal in developing the subsector is to create sustainable institutions, i.e. ones that cover their costs and generate a modest surplus for reinvestment. To achieve this goal, the institutions must attract the trust of savers/depositors, and motivate borrowers to repay.

The chapter compares supply and demand for microfinancial services. It groups institutions currently providing such services in Madagascar in three categories:

- Banks, comprising BTM-BOA with its long-standing agricultural credit program and the Caisse d'Epargne (CEM, a savings bank), which attracts many small deposits but invests them in government bonds rather than extending credit;
- Mutuelles d'Epargne et de Crédit (MECs, effectively savings and loan associations), which are membership-based; and
- Others, mainly microcredit institutions sponsored by NGOs.

Given that 75% of the population lives below the poverty line, 78% is rural, and 98% of the work force is engaged in the informal sector, the potential demand for microfinance services is close to the total number of households in Madagascar, roughly three million. Seventeen percent of these hold CEM deposits and 2% are MEC members, while BTM-BOA depositors/borrowers, the number of whom has decreased with the bank's reorganization, account for only 0.3-0.5%. The majority must resort to traditional sources, namely family, friends, suppliers and moneylenders, to cover financial needs.

The thrust of current government policy in microfinance is to develop the MEC subsector. This effort is focused on a 15-year, $38.5 million program of technical assistance/institutional development supported by the World Bank.

The chapter questions the current policy focus on MECs. It sees the MEC as an imported model, dependent on external resources to secure loanable funds and cover operating deficits. Much of MEC credit is described as supply-driven, arising from donors' imperative to disburse funds, with a concomitant risk of default. On the deposit side, many MEC members reveal a preference to keep any savings above the required minimum in BTM-BOA or CEM rather than in their MEC. International experience suggests that official expectations regarding the sustainability and impact of MECs in Madagascar are overly optimistic.

Development of MECs should continue; a promising approach is to enable financially viable MECs with large and stable funding bases from savings mobilization to "graduate" into self-standing restricted village or market banks. However, overall sectoral policy should pursue institutional diversification, product differentiation, and market segmentation.

The most successful microfinance intermediaries around the world are banks, both full-service commercial (such as BTM-BOA) and restricted-service (CEM). On the one hand, this indicates a need to stimulate the former to resuscitate and expand its rural lending, helping it to control costs and secure high repayment rates. For CEM, the need is to introduce loan operations in a phased, prudent manner. Issues of CEM governance, allocation of a reserve fund of retained earnings, and division of roles and responsibilities vis-à-vis government needs to be resolved.

Finally, since MECs do not take deposits from the public, the chapter calls for their supervision to be transferred from the bank regulatory agency, the Commission de Supervision Bancaire et Financière (CSBF), to a self-regulatory regime under an agency such as the APIFM.

Chapter 14 deals with the insurance sector. Most of it comprises a consultant report submitted in December 1997; a supplement to the chapter updates that report by examining how far the Insurance Code adopted by the National Assembly in June 1999 goes towards fulfilling the report's recommendations.

In modern economies, insurance plays two major roles: it protects agents against various contingencies, and it generates saving in the form of technical reserves that expand investment, thereby accelerating growth. In industrial countries, annual insurance premia range from 9 to 13% of GDP. With its level of only 0.6%, Madagascar falls below many African countries.

Since 1975 two state enterprises, ARO and Ny Havana, have dominated the sector. A third company controlled by the road transport industry, M.A.MA., claims over half of the automotive insurance market. Estimated total market shares as of 1996 were 53%, 39%, and 8% respectively.

In no small measure as a result of the state-run oligopoly, Madagascar's insurance sector lags far behind in supporting economic development. A unit of the finance ministry that has not published an annual report since 1983 and lacks the resources to conduct effective supervision nominally oversees the sector. De facto, regulation is left to the enterprises themselves, neglecting legitimate interests of the insured and agents.

The companies fight most bodily injury claims in court, delaying payment as long as possible. High overheads swallow over a third of premium income, as against an international norm of 20%. The companies lag in applying product innovations from the international market. Life insurance, in many countries a major source of saving, is offered on highly unfavorable terms, and only 200-300 policies are in effect. The fields of Agriculture, Credit, Assistance and Travel, and Surety are likewise neglected.

The burden on the insured is aggravated by a legal provision allowing insurers to transfer, tax-free, 15-16% of premia directly to a guarantee reserve, without provision for reinsurance. The government carries part of the blame for high premia by levying a 25% VAT. Taxes that total 50% on fire insurance and 31% on auto and accident insurance significantly discourage demand, encouraging the inefficient practice of self-insurance, and leaving a large share of commercial risks uninsured.

Paradoxically, these practices generate reserves, a substantial portion of which are invested in Treasury bonds and thus in a certain sense contribute to national saving. But this benefit is far outweighed by the distortionary impact of high insurance premia on the economy as a whole.

The 1999 Code addresses many of these shortcomings, but its true impact can be known only once the implementing decrees have been promulgated. The new Code completely abolishes the state insurance monopoly, and by encouraging the entry of new brokers, seeks to promote competition, stimulate the introduction of new and cheaper products, and make management more efficient. However, the existing companies will be spared competition during a two-year adjustment period following publication of the decrees.

The Code establishes the principle that holders of life insurance policies should participate in the technical and financial returns of companies that sell life insurance or insure capital assets. It provides for transparency of all types of charges. Foreigners are no longer excluded from investing in insurance in Madagascar. Rights of victims of automotive accidents receive enhanced protection.

However, the chapter expresses concern over the fact that the Code maintains a finance ministry unit as the authority responsible for insurance regulation. The ministry is in no position to exercise this function. An independent agency is required. Given that the market will remain strictly limited for the time being, it is probably best not to create a separate regulatory body devoted only to insurance, but rather to entrust this role to a specialized section of the CSBF.

CHAPTER 1

LINKS BETWEEN FINANCIAL AND ECONOMIC DEVELOPMENT IN MADAGASCAR

The question of whether and how far the financial sector can "lead" a country's economic development has long been a matter of debate. The two schools at opposite ends of the spectrum argue as follows:

1. Yes, a dynamic financial sector can stimulate saving, and then, in seeking profitable outlets for the saving, interact with entrepreneurs in such a way as to induce them to invest more and take greater risks to generate production, exports and employment than they would without the sector's stimulus; or
2. No, in the words of a famous British economist, "where enterprise leads, finance follows;" in other words, the sector responds more or less passively to demands for various levels of financial arrangements that arise as the economy's real sector develops.

As its theoretical point of departure the present study takes an authoritative review of financial development and economic growth published in a 1997 issue of the *Journal of Economic Literature* by a leading finance economist, Prof. Ross Levine.[2] The author looks for evidence to support the hypothesis that measures by which governments help the financial sector to advance, independently of the course of the real economy, act to "pull" the latter along. In the end Levine admits that the evidence is inconclusive—in other words, it has not yet been proven statistically that advances registered in the financial sector have "caused" the real economy to grow faster than it would have otherwise, as opposed to the alternative hypotheses that (1) demands posed by growth of the real economy have pulled the financial sector along, or (2) that the financial sector has developed *in anticipation of* future economic growth.[3]

However, Levine cites a body of evidence that carries important implications for Madagascar's financial development strategy. A cross-country regression on various factors hypothesized to explain the rate of growth of real per capita GDP, including but not limited to indices of financial development in year t, shows that the financial indices help to predict growth over the decade following year t.

Four indices figure in this analysis:

1. DEPTH, a measure of the size of the financial sector, gives the ratio of the sector's liquid liabilities—currency in circulation plus demand deposits and interest-bearing liabilities of banks and nonbank financial intermediaries—to GDP.
2. BANK, a measure of the role of commercial banks *vis-à-vis* the central bank, gives the share of commercial banks in total domestic credit, i.e. credit outstanding from commercial banks plus the central bank's net domestic assets.

[2] Ross Levine, *"Financial Development and Economic Growth: Views and Agenda"*, *JEL*, June 1997.
[3] Recent work inspired by the theory of "endogenous growth" concludes that the financial and real sectors act on one another continuously, such that the development of one promotes that of the other. The direction of causality thus becomes moot.

3. PRIVATE, a measure of the private sector's share in domestic credit, gives the ratio of credit allocated to private firms, excluding state-owned enterprises (SOEs), to total domestic credit net of credit to banks.
4. PRIVY, a measure of the importance of credit to the private sector in the economy as a whole, gives the ratio of credit to private firms (as in (3)) to GDP.

The hypothesis underlying the indices is that, the greater each one at time *t*, the more rapid an economy's future growth. In other words, (i) the deeper the financial sector (i.e. the greater its depth), (ii) the greater the role of commercial banks compared to that of the central bank, (iii) the greater the private sector's share in domestic credit, and (iv) the larger the credit outstanding to private firms in relation to the overall economy, the higher the economy's growth rate. The significance of credit to private firms arises from the assumption, according to Levine, that financial systems contribute to real growth by "researching firms, exerting corporate control, providing risk management services, mobilizing savings, and facilitating transactions"[4] with respect to the private sector, whereas systems engage much less in such activity to the extent that they simply funnel credit to government or SOEs.

For a sample of 77 countries, Levine finds significant correlations between averages of the four indices over 1960-89, and averages of three different growth indicators over the same 30-year period. The growth indicators are (i) real per capita GDP growth, (ii) growth of real per capita capital stock, and (iii) growth of productivity, defined as growth of real per capita GDP less 0.3 times (ii).[5] Other explanatory variables in the regressions control for initial income, extent of secondary education, and quality of monetary, trade and fiscal policy.

DEPTH is the most robust of the indices in "predicting" future growth. Its initial (1960) value for 57 countries is significantly correlated with 30-year averages of the three growth indicators. The implication is that a developing country (e.g. Madagascar) whose financial depth in 1960 was significantly below the average for low-income countries (see Table 1 below), would have attained significantly higher per capita GDP in 1990 had it started from that average value for DEPTH.

Table 1 compares 1985 values of the four financial indices for 96 countries, as computed by King and Levine (1993), with corresponding values for Madagascar in the four years 1986, 1991, 1994 and 1998. Also figuring in the table, for Madagascar alone (because King and Levine do not use it), is a fifth indicator, the ratio of commercial bank credit to GDP.

Of particular significance is the comparison with average indices for the poorest quartile (29 countries). At around 0.20, Madagascar's DEPTH index in three of the four years is well below the 1985 average of 0.26 for very poor countries.

By 1994 the Madagascar index had attained that average, but then a sharp acceleration of price inflation in 1994-95 (see Chapter 2 following) pushed it back down to 0.20 as of 1998. In other words, the policies responsible for accelerated inflation

[4] Levine 1997, p. 705.

[5] Productivity growth is a "Solow residual", measuring that portion of GDP growth not accounted for by increases in labor (for which population is taken as a proxy) and capital, assuming a 70-30 split of income between labor and capital.

pushed the demand for money back to its 1986 level, reversing the trend towards increased monetization of the economy, and penalizing savers.

Madagascar's relatively high level of BANK—in both 1991 and 1998 it approached the King-Levine 1985 level of 0.73 for rich countries—appears anomalous. In reality, the 1991 level reflects the large share of domestic credit accounted for by the three state banks, BNI, BFV and BTM, which were already then technically bankrupt as a

TABLE 1 - FINANCIAL DEVELOPMENT AND REAL PER CAPITA GDP

Indicator	Sample of 96 countries (King & Levine, 1993)					Madagascar			
	Very rich	Rich	Poor	Very poor	Correlation with real per capita GDP in 1985	1986	1991	1994	1998
DEPTH	0.67	0.51	0.39	0.26	0.51	0.20	0.21	0.26	0.20
BANK	0.91	0.73	0.57	0.52	0.58		0.72	0.60	0.72
PRIVATE	0.71	0.58	0.47	0.37	0.51	0.28	0.62	0.62	0.56
PRIVY	0.53	0.31	0.20	0.13	0.70	0.11	0.15	0.15	0.09
No. of countries	29	29	29	29					
					COMMERCIAL BANK CREDIT/GDP:		0.17	0.14	0.09

DEPTH = (liquid liabilities of fin. system (currency + demand & interest-bearing liabilities of banks)) / GDP
BANK = bank credit / (bank credit + central bank domestic assets)
PRIVATE = credit allocated to private enterprises / total domestic credit (not including credit to banks)
PRIVY = credit allocated to private enterprises / GDP

result of nonperforming loans. In contrast, the 1998 level reflects a much healthier composition, whereby two of the three state banks had been privatized, new foreign private banks had started operation, and central bank (BCM) credit to the economy had been brought under control.

The relatively high proportion of bank credit allocated to the private sector (PRIVATE) in 1991 and 1994, when it exceeded the King-Levine 1985 average of 0.58 for rich countries, is misleading. The leading "private" borrowers were entities established by politicians and awarded quasi-monopoly privileges by the government to import rice and other commodities; their main sources of credit were the two remaining state banks, BFV and BTM (BNI having been privatized as of 1st January 1991). To sustain this blatantly corrupt arrangement, in 1993(?) the government replaced the finance minister, the BCM governor and the BTM management.

The fourth indicator places credit to the private sector in the overall economic context, yielding a 1998 value of PRIVY only 70% (= 0.09/0.13) as high as the 1985 average for King-Levine's poorest quartile of countries. This represented a 60% reduction (from 0.15 to 0.09) from the levels in 1991 and 1994, when Madagascar exceeded that average.

The sharp drop reflected a combination of the demonetization that followed the 1994-96 inflation; the banks' increased caution in lending to the private sector as a weak legal-judicial environment created problems of loan collection; and the reintroduction of Treasury bills in 1993, whose outstanding balance at end-1998, most of it held by commercial banks, represented 3% of GDP. Similar phenomena explain the sharp drop in the fifth indicator, the ratio of commercial bank credit to GDP.

The following chapters trace the post-1991 evolution of Madagascar's economy and financial sector in detail. The object of the present discussion has been to establish a comparative framework for evaluating the country's low level of financial development, and to cite international evidence suggesting that removal of barriers to financial development in Madagascar may have a high return by way of accelerating real economic growth.

Stakeholders concerned with analysis of the financial sector and connections between them

The present study has sought to touch on all aspects of the financing of the Malagasy economy, as well as all relevant stakeholders. The following chart (Figure 1.1) shows how the different reforms analyzed affect the actors, and how the connections among them operate.

In the public sector, the agencies concerned are the Treasury, notably through its borrowing, the Central Bank of Madagascar, and the reforms affecting the operation of the commercial banks.

Thus, for this sector, a chapter on macroeconomic reforms establishes the context and impact of the reforms and their connections with financial development. Other chapters concern monetary policy, bank regulation and the Central Bank's role. One chapter is devoted to the financial operations of the public sector. Also analyzed are the legal environment and privatization strategy.

The chart shows the relevant **private sector** actors, taking into account different categories. The dimension called "units of production" is emphasized, because financing needs and the means of satisfying them differ according to the size of the units.

The three categories are:

1. Large and Medium Enterprises (LMEs): these are concerned with bank reforms, financial innovations (securities market, e.g. commercial paper), possibility of establishing a stock exchange…
2. Small and Medium Enterprises (SMEs): concerned with leasing as well as establishment of a securities market and cash management—see chapter on financial innovations;
3. Very Small and Micro Enterprises (VSMEs): their financing is analyzed in the chapter on microfinance.

LA REFORME DU SECTEUR FINANCIER A MADAGASCAR

Organigramme montrant que l'étude CAER est "intégré"

(tous les agents économiques, àdivers niveaux, sont touchés)